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SENSITIVE
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TAGS: ECON ETRD EAID EFIN ENGY PK
SUBJECT: CABINET OKAYS IMF PROGRAM BUT NOT SMOOTH SAILING WITH PUBLIC

¶1. (SBU) SUMMARY. The Federal Cabinet approved the economic stabilization plan and directed the Ministry of Finance to finalize negotiations with International Monetary Fund (IMF). The Planning Commission received reports on both short-term stabilization and medium-term economic recovery. The reports will facilitate an indigenous action plan and a roadmap for donor negotiations. However, recommendations like taxing agriculture are already facing stiff resistance. Meanwhile, the Government has again delayed a decision on an expensive campaign promise of reinstating 8,764 government workers fired for political affiliation. Market leaders, however, report improved sentiments since Pakistan approached the IMF. END SUMMARY.

CABINET APPROVES IMF PROGRAM

¶2. (SBU) Local press reports that on November 19, the Federal Cabinet approved the economic stabilization plan and directed the Ministry of Finance to finalize negotiations with IMF for reaching a formal agreement. The special Cabinet meeting concluded that accepting IMF facility was the only option to stabilize the economy and work toward development and prosperity. The Advisor to the Prime Minister on Finance, Shaukat Tareen, briefed the meeting on the latest interactions between the government and the IMF. Tareen told the Cabinet the IMF will accept Pakistan's "home-grown Economic Stabilisation Plan." Tareen told the Cabinet that the Standby Facility will be spread over 23 months, involving USD 7.6 billion at an interest rate of 3.51 percent to 4.51 percent, with a minimum of USD 3.2 billion credited to the State Bank of Pakistan (SBP) account in New York immediately after IMF Board approval. Foreign Minister Qureshi told the Ambassador, November 20, that the discussion in the cabinet had been spirited. He said that Dr. Hafez Pasha briefed the Ministers and advised that the IMF program tracked closely with his panel's assessment (see below).

T-BILL AUCTION SHOWS COMMITMENT TO REFORM

¶3. (SBU) One of the central components of Pakistan's program discussions with the IMF has been to allow interest rates to become positive again, in real terms, by raising the policy interest rate. Among the economic distortions the low policy rate caused was a reliance on central bank financing of the federal deficit. The IMF closely watched the T-bill auction on November 19, to make sure the target of Rs75 billion (USD 951 million at 78.88 rupees per dollar)

was fully subscribed. The SBP sold a total of Rs103.5 billion (USD 1.3 billion). SBP sold Rs101.6bn (USD 1.29 billion) in 3 month bills and Rs1.9bn (USD 24 million) in 6 month bills at 13.85 percent and 14.01 percent respectively. It rejected all bids for 12-month bills. COMMENT. IMF and donors consider this a successful auction, as the full targeted amount was sold, although the SBP appears to have targeted the shorter end of the yield curve for lower rates. END COMMENT.

ECONOMIC STABILIZATION PLAN RECEIVED

¶4. (SBU) On November 18, Prime Minister Gilani officially received the report Pakistan's Planning Commission requested from the "Panel of Economists" formed in September. The panel, headed by Dr. Hafiz Pasha, was instructed to prepare a short term economic stability report and a medium term growth strategy. Pasha is a well known economist of Pakistan and a former Planning and Development Minister. Gilani said that the report will help policymakers to formulate an indigenous action plan and give them a clear roadmap for donor negotiations. The report discusses the issues of non-competitive industry and consequently non-competitive exports, a distorted price structure which encourages consumption over production, large fiscal and current account deficits, and a need for social safety nets for the poor.

¶5. (SBU) One of the important panel suggestions is to have adequate and well-targeted social safety net programs in anticipation of the slowdown in economic growth and resultant unemployment. Pakistan must tighten monetary and fiscal policies, especially by raising

interest rates and cutting development expenditures. The economists believe development expenditure cuts will help to free up resources for social safety nets, especially to protect the poor during the expected economic slowdown.

¶6. (SBU) The panel proposed a number of stabilization measures, including taxing the services and agricultural sector, taxing the real estate and capital gains to generate revenue and also to curb speculation, cutting development expenditures, letting the exchange rate depreciate further to overcome overvaluation, correcting the price structure in order to encourage production and competitiveness, and adding a clause to the Fiscal Responsibility and Debt limitation law to restrict the government borrowing from the State Bank.

¶7. (SBU) The economists estimate that 75 billion in additional taxes can be generated through imposition of regulatory duty on non essential imports, imposition of excise duty on non essential consumer goods and services, and an agricultural tax. Another suggestion is to start only those development projects that have high employment intensity. They recommend that the focus should be on ongoing projects that have already been implemented.

PARLIAMENT OPPOSES AGRICULTURE TAX

¶8. (SBU) Much of the domestic criticism of the IMF program is the accusation that the IMF will require a federal agricultural tax. The Business Recorder reports that in the National Assembly on November 18, the ruling as well as opposition legislators said any move to tax agriculture will be resisted tooth and nail and that every farmer would take to the streets. The parliamentarians said high diesel and other input costs had made life harder for the growers. The Business Recorder reports that on November 19, Tareen explained that contrary to the general impression in the country, IMF has never asked specifically for levying a tax on the agriculture sector. Tareen said the IMF only asked for improved tax enforcement and increasing the tax to GDP ratio from 11 percent to 15 percent.

¶9. (SBU) A panel of Pakistani economists prepared a proposal to widen the tax base by including the agricultural sector. At this

time there is no detailed proposal, just a recommendation and a broad outline. The proposal would apply generally to all farmers but particularly the mid to large feudal landlords. One tentative formulation in discussion within the Government is to exempt all landholdings up to a threshold from any taxation and then apply a decreasing marginal tax rate for the remaining acres. For example, if the tax is to be levied on land holdings of more than ten acres, then a farmer with 100 acres would pay no taxes on 10 percent of the total income (the first ten acres). The remaining 90 percent of declared income would be taxed based on a declining marginal schedule based on the amount of land in use; in the example the remaining 90 acres. Thus, the larger the landholding the more favorable this particular proposal becomes.

¶10. (SBU) Government technocrats and the urban industrialist class support the general proposal and have repeatedly supported such initiatives. The landholders are protesting. The former Minister for Industries, Jehangir Tareen, opposed any such idea even before it was made public. He spoke against it again on November 3, in an Aaj TV program, arguing that the agriculture sector was already paying many taxes and imposition of new tax will gravely discourage the growers. At the activist's level, the Farmers Association's President, Zahid Hussain Gardezi has also condemned any such proposition. He described it as an obstruction that will depress and demoralize the farmers. Gardezi said that policymakers make recommendations without stakeholders input. Many legislators in the National Assembly have criticized the proposal, saying that the economic panelists lack even an elementary understanding of the agriculture sector in Pakistan and were overly focused on the little revenue it would generate.

¶11. (SBU) The proposal has not entered the legislative process. After this broad outline prepared by the panel of economists, the government will prepare a detailed proposal that would be presented to the IMF Board. After consulting with the IMF, the Ministry of

Finance (MoF) will work directly under the supervision of the joint task force on the agriculture tax. This task force work under a Policy Board of the Planning Commission and is expected to have technocrats, professionals, politicians and farmer representatives. Prime Minister Gilani and President Zardari will jointly chair the Policy Board. Unless legislators demand direct input, the MoF will work on the proposal as a technical matter and will directly prepare and present its recommendations to the Cabinet for approval.

¶12. (SBU) COMMENT: The probability that the proposal will progress is low. Similar proposals in the past have been unsuccessful. International financial institutions have repeatedly pushed for an agriculture tax but the powerful lobbies of the feudal landlords prohibited it. Large landholders are heavily represented in nearly all of Pakistan's political parties including the party currently in control of the government (the Pakistan People's Party). Gilani and Zardari each own significant landholdings and reportedly have poor tax compliance records. END COMMENT.

COMMITTEE CONSIDERS REINSTATEMENT OF WORKERS

¶13. (SBU) On November 5, the Cabinet decided to delay any decisions on the reinstatement of workers until further evidence is gathered about individual causes of dismissal. On July 2, the Cabinet decided in principle to reinstate workers of public sector organizations and corporations fired in 1996-1997 on the basis of their affiliations with PPP. Local press reports that as many as 8,764 employees may have their seniority and financial benefits restored from the date of termination. A committee headed by the Minister for Inter Provincial Co-ordination, Raza Rabbani, has been tasked to consider the modalities of the reinstatements and prepare recommendations for the Cabinet. Rabbani reports to Post that the committee met to discuss on November 18, but has not formulated recommendations on the amount of pay, benefits, or promotions workers would receive. The committee does not even know how many people would benefit but requested the number of employees fired for political reasons during the three-year period from ministries.

¶14. (SBU) On November 5, Information Minister Sherry Rehman explained the commitment to rehire the workers. She said, "The PPP had pledged in its manifesto to reinstate the fired workers and it would implement the decision regardless of the financial implications. Finances would be carved out in the light of proposals of the committee."

AMBASSADOR MEETS WITH CITIBANK EXECUTIVES

¶15. (SBU) On November 19, the Ambassador met with Arif Usmani (Managing Director and Citi Country Officer), Mir Aziz Rahman (Director and Head of Global Corporate Banking), and Yousaf Ahmad (Vice President and Bank Head) from Citibank. The executives said markets have become relatively calm since November 14, approximately when Pakistan officially approached the IMF for a Stand-by Agreement. They observed less precautionary hoarding of cash and fewer investments based on speculation.

¶16. (SBU) Usmani noted that, while the corporate banking market has been profitable, the small business and consumer credit portfolios are facing heavy losses. He explained that since Pakistan lacks credit agencies, banks are unaware of borrower's other debts. The rapid increase in interest rates, from 7 percent to 15 percent, is exposing just how overextended some borrowers are. In response to the EconCounselor's inquiry into the strength of the textile sector, Rahman replied that reports are varied. Of the sixty or so major names, twenty or so have serious issues while the remainder are doing quite well. Ahmad said many of the smaller companies are highly leveraged and will suffer from rate increases. Usmani attributed it to poor management; saying "conditions are bad, but you have to manage them."

PATTERSON